John Cole Scott On Where Closed-End Funds Stand At Mid-Year

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed John Cole Scott, President of Closed-End Fund Advisors and Chairman of the Active Investment Company Alliance. Read the Q&A below as John provides an update on what's been happening with closed-end funds throughout the first half of 2024. He notes that discounts narrowed almost across the board, but yields increased, resulting in positive returns for most asset classes.

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: John Cole Scott of Closed-End Fund Advisor is here and we're looking at the state of the closed-end fund industry at the year's midway point, this is The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, which is a unique industry organization representing all facets of the closed-end fund industry from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator will point you in the right direction. Joining me today, John Cole Scott, the president at Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com, and we're about to dig into funds using the firm's research, and you can do that for yourself at CEFData.com. John's also the chairman of the Active Investment Company Alliance, which you can learn about at AICAlliance.org. John Cole Scott, let's get busy.

JOHN COLE SCOTT: It's great to be here, Chuck.

CHUCK JAFFE: We are looking at the closed-end fund space in the middle of the year. Now we should point out you guys do presentations about this, and we've got a link in the description that will get people to the quarterly numbers if they want to dig in themselves. So we're going to turn what was a long presentation into a quick summary, but let's start with where closed-end funds are in terms of assets.

JOHN COLE SCOTT: So our universe of funds are about $829 billion in gross assets, around 789 funds at the end of the second quarter. If you look at the traditional, more historical closed-end fund listed structure, about $312 billion in assets, about 416 funds, that's about $750 million on average. Breaking them into three major groups, $144 billion across 174 funds, that's for the equity ones. Taxable bond funds, $83 billion and 133 funds. Municipal bond funds, $85 billion and 111. Some small changes since last quarter. Nuveen continues to be the largest sponsor by assets with $54 billion, 45 funds across 18 sectors. BlackRock, the largest number of funds, $48 billion and 51 funds across 22 sectors. Business-development companies, another related strategy we cover heavily on The NAVigator and in our firm, there are total BDC assets of $344 billion in gross assets and 154 funds, a lot of growth since last quarter. Fifty listed BDCs with $147 billion, pretty much the same, 103 non-listed or private BDCs with $195 billion, that's where the growth has been majorly coming from. Remember, earning's season starts next week, July 30th, with a two-quarter outlook of probably some strong results. Interval funds and tender-offer funds, there's 104 interval funds with $99 billion, a $10 billion increase since last quarter, and 10 years ago only 22. Tender-offer funds, pretty stable with 115 funds and $74 billion in assets. Non-BDC, very similar to last quarter.

CHUCK JAFFE: Where do discounts stand right now?

JOHN COLE SCOTT: The average CEF discount is at 6% for closed-end funds with a 25-year median around 4.2%. Month-end discounts have been wider about 24% of the time, still attractive but not crazy wild as we spoke the last two quarters. Equity closed-end funds are an 8.5% discount versus the 5.5% median, and month-end's wider about a quarter of the time. The outliers in that group of funds was MLP funds down to a 9.8% discount, during the quarter about a 2.5% narrowing, and covered-call equity funds to a 6.3% discount, narrowing about 1.5% during the quarter. Taxable bond funds are down to a 2.6% discount quarter-end, compared to the 25-year median of a 3.6%, so the first group in a long time to be above their peer group average over time, and month-end wider, 59%, so not frothy but still relatively well valued. And the outliers there were international bond funds, narrowed 2.8%, and senior loan funds and preferred funds narrowed 1.8% during the quarter. Muni closed-end funds down to a 8.4% discount at the end of the quarter, about 1.6% narrowing, not as much as last quarter but still significant, and 99% of the funds are at discounts and only 10% of the time discounts wider versus the beginning of the year where that was 1%. BDCs, 40% were at premiums with an average 1% discount to NAV and a 19-year median of 2.9% for the sector.

CHUCK JAFFE: Discounts have been getting narrower, that means you need to make your money a little more on yield. Are funds making more money on yield?

JOHN COLE SCOTT: It is, and we're going to use the 15-sector index at CEF Data to benchmark this, but at the end of the quarter about a 10.1% blended yield for the 100 most liquid funds across 15 sectors, and in concept about a 2% discount sitting there, so for 98 cents you're controlling $1.23, which is similar ratio in the past, about 25% more oomph for the market dollars in your portfolio. And the one-year dividend growth rate is 15%, and if you listen, we really talked a lot in the session about a lot more fake yield, more than even normal in my entire career because of defensive strategies by closed-end fund sponsors to narrow discounts by enticing investors, which at a discount is not terrible we talk about, it just means you can't spend every dollar you collect. Looking at leverage costs across the sector, which is a key part of these distributions, it's ticked up a little bit, 5.5% to 6.9% is the taxable fund normal range, there's about $73 billion dollars in total leverage in the closed-end fund universe and equity funds currently have that 8.2% yield, low leverage 13%, taxable bond funds hit that average of 10% with 25% leverage. Muni's up to a 5.7%, big increase but not because of rates obviously, defense there with 31%, and the average cost of leverage for the munis is up 4.9%. The key for munis is that tax-driven investor for the highest earners in this country, that's a 9% tax equivalent yield based on our outlook. The average duration is stable at 11, relatively high versus other investments, but if you're thinking interest rates won't go up, great place to be. And BDCs, very stable at a 10% yield, and leverage ticked down slightly to 50%.

CHUCK JAFFE: So yield is doing well, again discounts narrowing, that should be good for performance.

JOHN COLE SCOTT: Yes, so great quarter for the industry, about a 2.6% quarter date market price performance for that index of 15 groups of funds. Only a 1.75% NAV, which again is about 90 basis points of discount narrowing. And again, just to benchmark the year, we're halfway through, 11.1% market price total return for the year and a 6.5% NAV. At the start of the year we talked about where we might do versus the S&P 500 equal weight, I double checked that, that was off 2.6% in the second quarter but up 5% year to date. Eighty-one percent of closed-end funds were positive on their market price total return for the quarter, down a little bit from last time. REIT real assets, really the outlier, only 30% of the funds were positive because of issues in that sector during the quarter with the outlook for the market. And again, it's noteworthy, similar to last quarter, 90% of closed-end funds were positive market price performance, but unlike last quarter 90% were also a higher number but positive on NAV.

CHUCK JAFFE: Now we get to the stuff where things go from here's where the money is to here's what's happening next. It was a very busy proxy season during the first half of the year.

JOHN COLE SCOTT: It was, and I think that our clients, maybe our listeners, have their mailman making extra money from all the tons of proxy materials if you didn't vote in your mailbox. We had a very big season, a large battle of note between Saba and BlackRock, a lot of press coverage. Saba's up slightly higher to $4.3 billion in assets, Karpus is holding $2.4, SIT $2.2, Allspring, $1.2 billion, City of London at a billion, 1607 Capital down slightly to $900 million, Lazard up slightly to $565 million in these investments of closed-end funds, and Bulldog right just under $200 million. Some of these are more active than others, of note this totals about $12.8 billion of these more active 13 filers, and that's up from about 5% last quarter, 5.6% of the universe's market cap. And really, things to talk about would be that BlackRock considers this a victory, and we think BlackRock's a good manager and does a good job, but they didn't get as many votes as Saba. They're following the rules in place, but I do expect some interaction with the courts. I'm not a lawyer as you know, and I'm not in the court system, but I do expect possibly some negotiations around potential outcomes in the way those votes turned out. And there's been lots of tenders, and tenders are usually the outcome from these campaigns, either early in the process or deeper. One example was a ClearBridge fund, CTR, we owned it for clients, they did a 50% tender as part of their negotiation with Saba, and we tendered all of our shares and we got like 92% of them, which reminds you how many investors don't vote their proxies. When a 15% discount fund offers you half, 98 cents on the dollar, the next day bought back that money for 13% guaranteed relative arbitrage, but we need more people voting their tenders and paying attention to what's going on to really benefit from closed-end funds.

CHUCK JAFFE: Coming up in the news, Bill Ackman's got a new closed-end fund coming out.

JOHN COLE SCOTT: Yeah, there's been much commentary in Bloomberg, been talking to some reporters there. Initially it was seeking a $25 billion IPO, the largest ever, nudged it down to $10, but my sources today say they've seen about $2.5 before Monday's close and should hit closer to $4. I think it's a great idea, I'm thoughtful on the way he's going to have only a 1% net fee to create the fund with the average 5% being historically the same. It's a sister to his UK fund meant for retail investors. We're optimistic for it, but I'd say cautious. We're not choosing to be on the IPO, but we welcome into the sector. He's been very open to our questions and many others, and hope he's a great added benefit the US market for investors.

CHUCK JAFFE: Something I know we'll be talking about in the not too distant future, there's a proposal now that would remove annual meetings. Talk about putting a damper on activism.

JOHN COLE SCOTT: Thank you for bringing that up. I mean, at a basic level, we're pro structure as you know, but we think common stock shareholders, whether they own a hundred shares or a million shares, have a right to that ownership. When your common stock price can dislocate from net asset value, unlike an active ETF or a non-listed fund, I think it's important to have a vote in the board, in the manager, and the process, and we'd like to see a comment letter from those in the industry support the rights of investors while also making sure that good sponsors are able to do good work for their shareholders.

CHUCK JAFFE: All of the numbers that we talked about were looking at past performance, the stuff we're talking about with the activism, that is happening now. Last question, what's next?

JOHN COLE SCOTT: Well, we really think that it's important as you continue to manage your own portfolio for your clients or maybe your own as an investor to do tax-loss swapping. Just in the last month we rotated out of BDCs and muni funds for net neutral taxation to our taxable clients while keeping the asset allocation in the dividends and sturdy terms, and a very useful thing, we've done that over nine times in the last three years for many of our larger clients. It's also really important to understand your marginal tax rate for qualified dividends versus hairy dividends versus differed dividends like return on capital and then tax-free for muni, and make sure your marginal rate for your portfolio of taxable investments, you're not getting hit with huge taxes, think 1, 2, 3% of your portfolio paid to the federal government, as patriotic as we all are, be really thoughtful there. And again, we don't have to know what's going to happen in November, we're diversified, we pick managers, we pick discounts, and we rotate based on what happens next, we don't have to fully plan for what happens next. I think that's the beauty of a closed-end fund investor, the discount tailwind and the ability to rotate during the market day.

CHUCK JAFFE: Well, we don't have to fully plan what happens next, but we do plan to talk with you again in the not too distant future. John, always great to have you on The NAVigator.

JOHN COLE SCOTT: Enjoyed being with you, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, I am Chuck Jaffe, you can learn more about my work and my show at MoneyLifeShow.com or by going to your favorite podcast app. To learn more about closed-end funds, interval funds, and business-development companies go to AICAlliance.org, that's the website for the Active Investment Company Alliance, they're on Facebook and LinkedIn @AICAlliance. Thanks to my guest, John Cole Scott, he's president of Closed-End Fund Advisors in Richmond, Virginia, and he's the chairman of the Active Investment Company Alliance. His firm is online at CEFAdvisors.com and you can dig into the data they develop at CEFData.com, and John is on Twitter or X, if you will, @JohnColeScott. The NAVigator podcast is available every Friday, make sure you don't miss an episode by following or subscribing on your favorite podcast app. We'll be back next week with more closed-end fund talk. Until then, happy investing everybody.

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